92-SBE-003

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 89R-1165-MW
BAUER STOCK TRUST, EDWARD	)	
LANDRY AND JAMES HASSAN,	)	
TRUSTEES	)	

Appearances:

For Appellant: William J. Stirton
Coopers & Lybrand

For Respondent: Karen D. Smith
Larry Bobiles
Counsels

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a),[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Bauer Stock Trust, Edward Landry and James Hassan, Trustees, for refund of personal income tax in the amount of $68,825 for the year 1983.

[1/] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the taxable years in issue.

The issue originally raised in this appeal is whether appellant was entitled, under the special small business stock provisions of Revenue and Taxation Code section 17063.11, to exclude from tax preference income capital gain from the sale of stock which it had received as a gift at a time when the stock did not meet the small business stock qualification requirements. The Franchise Tax Board (FTB) has also asked this board to reconsider its holding in the Appeal of Magnus F. and Denise Hagen, decided by this board on April 9, 1986.

Casa Blanca Convalescent Homes (Casa Blanca) was incorporated in California in June 1966 and William Bauer, Casa Blanca's founder, acquired shares in the corporation in that same month. Mr. Bauer also created Bauer Stock Trust, the appellant here, as an irrevocable, non-grantor trust. On October 1, 1976, Mr. Bauer made a gift to appellant-trust of 1,023 shares of Casa Blanca. At the time of this gift, Casa Blanca had more than 500 employees.

Appellant sold its shares in Casa Blanca in May 1983 and reported gain from this sale as an item of tax preference. Later, appellant filed an amended return and claimed a refund of the preference tax, contending that the stock sold was small business stock and, therefore, the gain was excludable from preference income under section 17063.11. The FTB refunded the amount claimed, but, on subsequent audit, determined that the stock sold was not small business stock and did not qualify for the preference tax exclusion under section 17063.11. Appellant paid the resulting assessment and filed a claim for refund which the FTB denied.

Former section 17063.11[2/] provided: "For the purpose of section 17063 [defining items of tax preference], that portion of capital gains attributable to the sale of small business stock, as defined in section 18162.5, is not an item of tax preference." Former section 18162.5,[3/] subdivision (e), provided, in pertinent part:

> (e) For purposes of this section, "small business stock" is an equity security issued by a corporation which has the following characteristics at the time of acquisition by the taxpayer:
>
> * * *
>
> (2) The total employment of the corporation is no more than 500 employees . . . .

The FTB argues that the qualification for small business stock treatment is determined under section 18162.5 at the date the stock was "acquired," that the stock was acquired by appellant-

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[2/] This section was repealed by AB 53 (Stats, 1987, ch. 1138), operative for taxable years beginning on or after January 1, 1987.

[3/] This section was repealed by AB 53 (Stats. 1987, ch. 1138), operative for taxable years beginning on or after January 1, 1987.

trust in 1976 when it first received it from Mr. Bauer, and that the stock did not qualify as small business stock since it had more than 500 employees at that time.

Appellant agrees that the stock did not meet the qualifications for small business stock at the time the gift was made to the trust. However, appellant argues that the stock qualified as small business stock in 1966 when Mr. Bauer first acquired it and that the small business stock character carried over when the stock was transferred to the trust. It argues that Mr. Bauer, in creating and expanding Casa Blanca, fulfilled the purposes that the small business stock provisions were designed to encourage, by investing in California and creating new jobs here. Therefore, appellant concludes, we should not be bound by the common definition of "acquired" as we would be ordinarily. Instead, appellant argues, we should apply the provisions of the Internal Revenue Code (I.R.C.) (incorporated into California law by section 18151) which deal with the holding period and basis of property received by gift for purposes of determining gain or loss. Under these provisions, the donee of property takes the same basis in the property as that of the donor, and the holding period for determining gain or loss is determined by including the period during which the property was held by the donor before the gift was made.[4/]

Appellant concludes from these provisions that the date of acquisition of the Casa Blanca stock, for purposes of determining whether it was small business stock, was in June of 1966, when Mr. Bauer, the donor, acquired the stock. Appellant asserts that California law requires the definition of "acquired" to be the date when the donor acquired such property and that reliance on "such long-established principles regarding the definition of 'acquired' is necessary to satisfy the purpose of the Legislature in enacting the California small business stock provisions." (App. Br. [Aug. 30, 1989] at pp.

[4/] Appellant relies on the language from I.R.C. § 1223(2) and the corresponding regulation. The statute provides:

> (2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by another person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(I.R.C. of 1954, § 1223(2).)

Treasury Regulation § 1.1223-1(b) gives the following example:

> . . . the period for which property acquired by gift after December 31, 1920, was held by the donor <u>must</u> [emphasis by appellant] be included in determining the period for which the property was held by the taxpayer if, under the provisions of section 1015, such property has, for the purpose of determining gain or loss from the sale or exchange, the same basis in the hands of the taxpayer as it would have in the hands of the donor.

(Treas. Reg. § 1.1223-1(b).)

I.R.C. § 1015(a) provides that a donee's basis in property acquired by gift shall be the same as the basis of the property in the hands of the donor.

5-6.)

The FTB argues that one would generally not acquire stock before one obtains ownership, possession, or control, citing to the case of Knowlton v. Commissioner, 84 T.C. 160, 163, affd., 791 F.2d 1506 (11th Cir. 1986). Since appellant-trust did not have ownership, possession, or control of the stock until October 1, 1976, when Mr. Bauer transferred the stock to the trust, the FTB contends that that is the date appellant acquired the stock and the date on which the stock must have met the requirements of section 18162.5. Since it did not meet those requirements on that date, having then more than 500 employees, the FTB concludes that the stock does not qualify for the special treatment accorded small business stock by section 17063.11. The FTB contends that there is no reason to look behind the statute and its plain meaning, since it is clear on its face. Whether or not Mr. Bauer fulfilled the purpose of the small business stock provisions, FTB argues, is irrelevant, since the taxpayer that owned, sold, and reported the gain on the sale of the Casa Blanca stock was not Mr. Bauer, but the appellant, Bauer Stock Trust, a separate entity and taxpayer. As to appellant's argument that the basis and holding period provisions for gifts under the I.R.C. should be controlling here, FTB contends that there is neither judicial nor statutory authority for this proposition.

In the Appeals of Diane L. Morris Trust, et al. (89-SBE-019), decided by this board on August 2, 1989, we addressed the question of the meaning of "acquire" in the small business stock provisions. That appeal involved the acquisition date of stock received in a tax-free reorganization, and, in footnote 2 of that opinion, we specifically declined to consider the effect of certain gifts of stock which had occurred, since neither party had presented facts or legal argument on the issue. Here, we are presented squarely with the question.

While we did not decide the effect of a gift of stock in the Morris Trust appeal, supra, many of the same arguments, particularly those dealing with the applicability of holding period and basis carryover, were presented and considered in that appeal. Having considered those and other arguments, we concluded that the "the plain meaning of 'acquire,' as defined by the court in Knowlton, supra, does not lead to absurd results or thwart the obvious purpose of the statute." (Appeals of Diane L. Morris Trust, et al., supra.) We reach the same conclusion here, not only for the reasons discussed in Morris Trust, but also because here we have a new and distinct taxpayer. While holding period and basis may carry over for purposes of determining gain or loss, we reject the idea that the same carryover is thereby compelled for the small business stock character.[5/] An amicus curiae brief filed in support of the appellant's position insists that "the rules relating to the holding period for gifted stock should be applied consistently for all income tax purposes . . . ." (Am. Cur. Br. [by Leonard W. Rothschild, Jr., Esq.] at pp. 5-6.) While consistency is certainly to be desired whenever possible where the language and purpose of the statues are the same, we are here dealing with a situation in which neither the language nor the purpose of the statutes compared is the same. The small business stock

[5/] Cf. Knowlton v. Commissioner, supra, 84 T.C. at 168, where the court rejected the petitioners' contention that tax-advantaged transactions allow "acquired" to mean a date earlier than the date of actual receipt. The court stated that it was "clear that whether . . . the transferee receives a carryover basis and holding period [is] not determinative."

provisions do not determine whether there is gain or loss, or how much gain or loss but, where there is gain, they dictate certain circumstances in which exemptions from the general taxation statutes regarding capital gains are allowed. As exemptions from the general rule, these provisions should be narrowly construed. (See, e.g., Bingler v. Johnson, 394 U.S. 741, 752 [22 L.Ed.2d 695] (1969); Helvering v. Northwest Steel Rolling Mills, Inc., 311 U.S. 46, 49 [85 L.Ed. 29] (1940); Curtis v. United States, 336 F.2d 714, 721 (6th Cir. 1964).)

The FTB, in its Legal Ruling 428 (Aug. 19, 1987), analyzed and discussed various questions regarding the application and terminology of section 18162.5, including the general definition of "acquire" as used in that statute and the specific question of the acquisition date of stock which is the subject of a gift. We reiterate here the observation we made about that legal ruling in the Morris Trust appeal: ". . . that ruling appears, in general, to be reasonable and within the scope of the FTB's responsibility and authority as the administering agency [of the Personal Income Tax Law]." (Appeals of Diane L. Morris Trust, et al., supra.) We find no compelling reason to reach a conclusion here different from that reached in the FTB's legal ruling and which we previously approved in the Morris Trust appeal.

Based on the discussion above, we conclude that appellant acquired the Casa Blanca stock in 1976 when the corporation had more than 500 employees. The stock sold, therefore, did not qualify as small business stock on the date acquired. Appellant, therefore, is not entitled to the tax preference exclusion benefits of section 17063.11 for the unrecognized portion of the capital gains resulting from the sale of the Casa Blanca stock.

In its Supplemental Brief, the FTB raised, apparently for the first time, the issue of our board's reconsideration of its decision in the Appeal of Magnus F. and Denise Hagen, decided April 9, 1986, rehearing (requested by the FTB) denied July 29, 1986. Having decided that appellant is not entitled to the benefits of section 17063.11 because the stock sold did not qualify as small business stock on the date acquired by the taxpayer, we need not reach the alternative issue raised by the FTB. However, this issue is discussed, and resolved against the FTB, in the Appeal of Brian L. and Phyllis Harvey, decided this day.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Bauer Stock Trust, Edward Landry and James Hassan, Trustees, for refund of personal income tax in the amount of $68,825 for the year 1983, be and the same is hereby sustained.

Done at Sacramento, California, this 23rd day of April, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, Mr. Fong, and Ms. Scott present.

Brad Sherman, Chairman

Ernest J. Dronenburg, Jr., Member

Matthew K. Fong, Member

Windie Scott*, Member

________________________, Member

*For Gray Davis, per Government Code section 7.9

bauer.mvw